THE PERAC FINANCIAL BULLETIN

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A s seen in the recently published PERAC Annual Report for 2000, the investment characteristic that was most responsible for separating the best performing systems from the laggards last year was the proportion, and even more importantly, the makeup of their equity holdings. Overall, it generally paid to have lower rather than higher overall allocations to stocks as asset classes like fixed income and real estate flourished.

Specifically, in a year when traditional investors exacted sweet revenge against momentum players and fancifully priced "new economy" stocks, value stocks handily trounced growth stocks last year. Through the first half of 2001, that trend has persisted, even with growth stocks enjoying a modest comeback during the second quarter.

After a horrific twelve months that began with the bursting of the technology bubble in March 2000, the stock market's major indices finally had a quarter of positive performance. To many observers, the market's recovery reflected a good measure of hope that the economy may

be bottoming out and that stock prices had corrected enough. In actuality, the economy remained sluggish and companies in nearly every industry were reporting or projecting sharply reduced profits and continuing to trim their workforces. Despite the economic gloom, investors hoped that the tax cuts and rebates approved by Congress as well as the Federal Reserve's continued easing would eventually

"The market's recovery reflected a good measure of hope that the economy may be bottoming out and that stock prices had corrected enough."

spark a return to healthy growth.

The Fed's aggressive easing, totaling 275 basis points, has been perhaps the most significant event in 2001's financial news. The Board's move in late June was its sixth this year, although the reduced magnitude (25 basis points rather than the 50 basis points done in

COMMONWEALTH OF MASSACHUSETTS PUBLIC EMPLOYEE RETIREMENT ADMINISTRATION COMMISSION





each of the previous five moves) indicated that its loosening of monetary policy might be coming to an end. In a statement accompanying its June action, the Fed noted concern over: "declining profitability and business capital spending, weak expansion of consumption, and slowing growth abroad."

Economic growth has indeed slowed but, estimated at 1% in real terms for the first half of

market and auto sales sluggish but reasonably stable. As slashed corporate capital spending remains the major depressant on the economy, some economists fear that even cheaper money might not be the answer to reducing the excess capacity and inventories that burden most companies.

The S&P 500 Index of large cap stocks was up 5.5% for the second quarter while still down

7.3% for the year-to-date and off 15.8% for the previous twelve months. The Russell 2000 Index of small cap stocks was up 13.9% for the quarter, is up 6.1% for the first half of 2001 and down only 0.8% for the trailing twelve months. The technology-laden NASDAQ Composite finally showed some life after its historic collapse; up 17.4% for the quarter, it is still down 12.6% year-to-date, 45.5% for the trailing twelve months, and 57% from its high in March 2000.

Through the first six months of 2001, value stocks have significantly outperformed growth, continuing the trend of 2000. However, as seen in the accompanying table (page 6), growth did outpace value during the second quarter. Even with this turnaround quarter, the magnitude of outperformance by value over growth over the

trailing twelve months was about 50% across the board, indicating that much of the inevitable correction between the two styles may have already occurred.

Given the correction among styles, subclasses, and sectors that has occurred, many analysts feel that the market lacks any specific areas of opportunity. Now that it has been

S&P 500 VS. NASDAQ: YEAR-TO-DATE

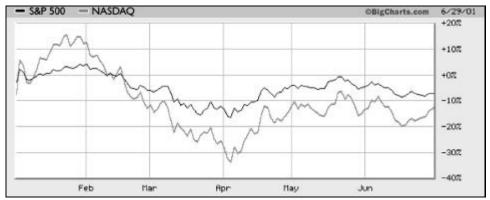


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BACK TO THE MEAN: THE NASDAQ BUBBLE BURSTS 12/31/98 - 6/29/01

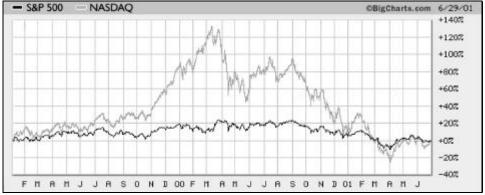


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2001, is still positive. Industrial production declined for eight consecutive months and new capital goods orders fell to their lowest levels in two years. Nevertheless, the corporate cutbacks in capital spending, particularly in the technology sector, that have led the slowdown haven't dragged down the rest of the economy. The consumer sector has held up well with the housing

proven that the sector is not immune to normal business cycle risk, strategists see the technology sector as being particularly perplexing. They are unsure whether to consider tech stocks to be growth or value; the previous projections for unfettered rapid earnings growth have been totally discredited but the stocks are still not priced attractively enough by historic standards to be called "cheap".

Performance among stocks was largely company-specific. Through the first six months, a reinvigorated and re-focused Microsoft was up 68% while another major software company, Oracle, was down 35% and network equipment maker Cisco, which had the market's highest capitalization in early 2000, continued its drastic correction, falling 52%. AOL Time Warner was up 52% and IBM advanced 34%, but Merck fell 32% and Coca Cola 26%.

The combination of a strong dollar and sluggish overseas economies served to continue the disappointing results of international equity as a diversifying asset class. In Europe, the central bank has not been as decisive as the Fed in lowering interest rates and the major economies of France and Germany appeared to be slowing rather than recovering. Asian markets were generally mixed but investors were increasingly concerned that Japan, despite new leadership, was still mired in a no-growth muddle. Some emerging markets have done well, particularly Mexico, where the new Fox administration has buoved investor confidence.

In the fixed income market, returns from bonds were modestly negative during the quarter. Bond traders are generally a humorless, morose lot; they derive satisfaction from a slowing economy where job losses are mounting (except if it's their own jobs affected) but are positively miserable when the economy shows signs of recovery or, heaven forbid, exuberance. Thus, while short-term Treasury yields generally declined in sympathy with the Fed's repeated lowering of the Federal Funds rate, long term

rates rose as traders were despondent over prospects that the Fed might actually accomplish its goal of rescuing the economy. Rates on tenyear Treasury notes increased more than 50 basis points during the quarter to 5.45% while the 30-year bond yield rose 35 basis points to 5.75%. The historically wide yield spreads between Treasuries and corporate bonds narrowed slightly as expectations of an

THE U.S. STOCK MARKET: A LONG VIEW

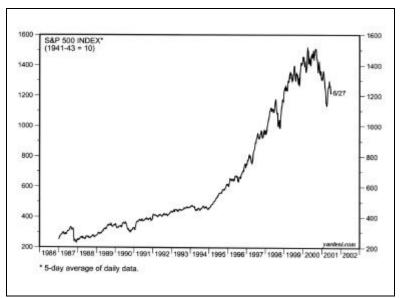


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BONDS: CORPORATES ARE STILL ATTRACTIVE



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improving economy raised confidence in the corporate bond market. Similarly, mortgage-backed bonds also outperformed Treasuries. The high-yield sector remained under pressure amid expectations of increasing defaults by troubled telecom issuers.

In real estate, there has been anecdotal evidence of softening in rental markets nationwide and rising vacancy rates have been reported in

A TALE OF TWO SECTORS (#1)



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A TALE OF TWO SECTORS (#2)



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some areas acutely affected by the dot-com crash and the technology slowdown. Nevertheless, this asset class continues to offer investors positive returns with low correlation to the stock or bond markets. Publicly traded REITs had an exceptionally strong quarter, rising 11%, while returns from the private market appeared to be moderating but still healthy. Reported returns have been reasonably consistent along either regional or sector lines. Considering the surprisingly strong performance of REITs in the face of a general weakening in real estate fundamentals, some strategists feel that this sector may have become overvalued, having come full circle from its period of very disappointing performance in 1998-99. Having been previously overlooked by investors obsessed with large cap growth stocks, the REIT market may have become over-bought by investors recently frustrated with the lackluster returns from stocks.

Although actual reported returns are subject to lags of at least three months (composite returns from this year's first quarter are not yet available), indications are that the reality of last year's dot-com meltdown in the public markets is finally catching up to venture capital partnerships. As the IPO market remains essentially closed and more and more start-ups are either ceasing operations or barely gasping for life, valuations of existing holdings are being written down to realistic levels, however painful it might be for the partnership. Financing for new companies is down considerably from prior levels as general partners focus their energies on what to do with the "problem child" companies already in their portfolios.

This year's results in the financial markets have continued to confirm the importance of diversified asset allocation. Aberrations in the market can occur and sometimes persist longer than expected, and they can reach extremes that make investors wonder whether a new order has occurred. Yet, markets inevitably revert to the mean and that's what we've been seeing over

the past fifteen months. After years of frustration, value stocks have been trouncing growth, small caps have outpaced large, and industries such as health care and financial services have assumed market leadership from technology stocks. Perhaps most importantly, stocks overall may well be in the midst of a period of unspectacular returns, in reaction to the well-above-trend results of the late 1990s, reinforcing the importance of maintaining allocations to other asset classes such as bonds and real estate.

At mid-year, there are uncertainties and questions about all major asset classes. Most importantly, will the economy sink into recession despite recent monetary and fiscal stimulation? Even if the economy recovers, how well will stocks do with valuations (i.e., price/earnings ratios) still high by historical standards? (See chart.) Will faster economic growth raise a red flag for inflation-wary bond investors? If the economy does fall into a recession, how badly will the real estate market weaken? When will the process of correcting lofty asset valuations by venture capitalists be completed? And for pension fund trustees, the fundamental question is how to achieve their actuarial rate of return during this period of weak returns in the major markets. To this questions, there are no easy answers other than to stay the course and don't stray from a program of prudent, diversified investing.

The PERAC Investment Unit welcomes your questions or comments. We encourage your ideas for ways we can be helpful and would welcome the opportunity to attend retirement board meetings to discuss matters of either general or specific interest.

STOCK MARKET VALUATIONS: LOWER BUT NOT LOW (#1)

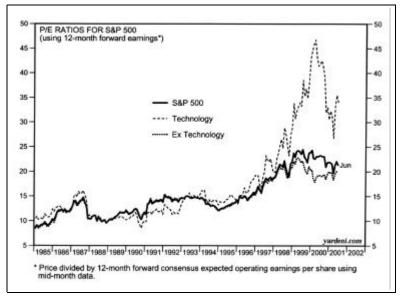


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STOCK MARKET VALUATIONS: LOWER BUT NOT LOW (#2)

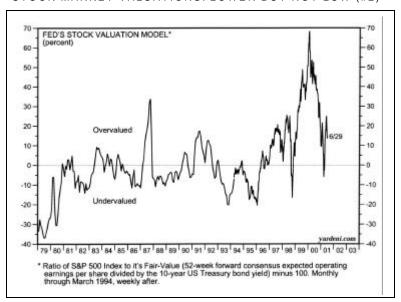


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SECOND QUARTER, 2001 | TOTAL RETURNS

| INDEX | SECOND QUARTER 2001 | SIX MONTHS 2001 |
|---|---------------------------|-----------------------|
| US EQUITY MARKET | | |
| Dow Jones Industrial Avg. | + 6.74% | - 1.83% |
| Standard & Poor's 500 (Large Cap) | + 5.85% | - 6.71% |
| NASDAQ Composite | + 17.40% | - 12.55% |
| Wilshire 5000 (Broad Market) | + 7.48% | - 5.79% |
| Russell Mid-Cap | + 9.52% | - 1.97% |
| Russell 2000 (Small Cap.) | +14.41% | + 6.96% |
| GROWTH VS. VALUE | | |
| S&P 500 Growth | + 7.71% | - 11.04% |
| S&P 500 Value | + 4.41% | - 2.41% |
| Russell Midcap Growth | + 16.16% | - 12.98% |
| Russell Midcap Value | + 7.04% | + 3.26% |
| Russell 2000 Growth | + 18.09% | + 0.14% |
| Russell 2000 Value | + 11.76% | + 12.84% |
| INTERNATIONAL EQUITY | | |
| M.S.C.I E.A.F.E. | - 1.24% | - 14.75% |
| M.S.C.I Emerging Markets | + 3.22% | - 1.87% |
| FIXED INCOME | | |
| Lehman Brothers Aggregate Index | + 0.56% | + 3.60% |
| Lehman Brothers Government/Corporate Index | + 0.30% | + 3.51% |
| Lehman Brothers High Yield Index | - 2.28% | + 3.93% |
| | | |
| REAL ESTATE | | |
| NAREIT - Equity Real Estate Investment Trusts | + 11.09% | + 10.79% |
| NCREIF Property Index | + 2.23% (Q1) | + 5.46% (Q4, Q1) |

Dow Jones Industrial Average

A price-weighted index tracking thirty large industrial companies selected by the editors of *The Wall Street Journal*.

Standard & Poor's 500 Index

A broad-based market index, weighted by market capitalization, that comprises about 75% of the total market value of publicly traded US equities.

NASDAQ

The National Association of Securities Dealers Automated Quotation System is an over-thecounter trading exchange used mainly by newer, technology-oriented companies.

Russell 2000

The major index that tracks small capitalization stocks.

Large Capitalization Stock

Total market value of outstanding stock exceeds \$5 billion.

Mid-Cap Stock

Between \$1.5-5 billion in market capitalization.

Small-Cap Stock

Less than \$1.5 billion market value of stock outstanding.

Growth Stock

Stock of companies that, due to their strong earnings potential, offer above-average prospects for capital appreciation, with less emphasis on dividend income.

Value Stock

Stocks that, considering a company's assets and earnings history, are attractively priced relative to current market standards of price-to-earnings ratios, price-to-book ratios, et al. They typically pay regular dividends to shareholders.

Price/Earnings Ratio

Sometimes referred to as the "multiple", the P/E Ratio is the stock price divided by the company's net income per share over the past twelve months.

Treasury Yield

The current market interest rate on bonds issued by the US Treasury with a specific maturity date (i.e. 30 years). Bonds are issued at a specific interest rate and at a specific price (such as 100 or "par") but the subsequent price and yield will be determined every day by prevailing market conditions. If rates generally rise (fall) after initial issuance, the price of the original bond will fall (rise) in order to make the effective yield on the bond rise (fall) to a level consistent with those on currently issued securities.

Corporate Bond Spread

The "spread" is the incremental yield offered by corporate bond issuers over those of US

Treasury securities of similar maturity. The spread is a measure of investors' willingness to assume the extra credit risk inherent in corporate securities compared to virtually riskless US Treasuries.

Federal Funds Rate

The rate at which reserve funds (\$1 million or more) are traded among commercial banks on an overnight basis.

High-Yield ("Junk") Bonds

Bonds rated below investment grade issued by corporations whose overall business or financial condition is relatively weak or risky. These bonds react less to general interest rate trends than do investment grade securities.